ALAGAPPA UNIVERSITY

(Accredited with 'A' Grade by NAAC)

Karaikudi 630 003

DIRECTORATE OF DISTANCE EDUCATION

494

MBA (B & F)

Paper - 4.5

Merchant Banking

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KARAIKUDI - 630 003. TAMILNADU.

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PAPER - 4.5 - MERCHANT BANKING

Merchant Banking: Meaning - Importance - Activities of a Merchant
1721 Banker: Project Counseling. Loan Syndication, Management of Public Issues, Underwriting, bankers to Issue and other services - Growth of Merchant Banking in India - Role of the SEBI in regulating Merchant Banking industry - Role of NSE and OTCEI.

Project related activities of a merchant banker: Corporate Counselling - Meaning - Problem areas of an enterprise - Organizational goals - Advisory role of a merchant banker - Loan Syndication: Meaning and scope, Steps in Syndication.

Capital Issue related activities of a merchant banker: Changing structure of Indian Capital Market - Management of pre-issue activities - Types and characteristics of corporate securities - Marketing of corporate securities - Steps to be taken by the issuing company and the lead manager - Underwriting - Management of post-issue activities - Processing of data - Reporting to SEBI - undersubscription - Bridge loans - Allotment of shares - Listing of Securities.

Service oriented activities of a merchant banker: Mergers and Amalgamations - Meaning - Purpose - Types of mergers - Role of merchant bankers in mergers - Portfolio Management - Functions of portfolio managers - Explanation to risk - CAPM - Approach to market operations.

Miscellaneous activities of a merchant banker: Venture capital - Origin - Administration of venture capital fund - Mutual Fund - Advantages - Classification of Mutual Funds - Factoring - Mechanism and types of factoring.

Text Book:

Machiraju H. R - Merchant Banking: Principles and Practice

Reference Book:

Dr. Verma J. C - Bharat's Manual of Merchant Banking

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MERCHANT BANKING

MEANING - IMPORTANCE - ACTIVITIES

Section 5 (b) of Banking Regulation Act 1949 defines banking as accepting for the purpose of lending or investment, of deposits of money from public repayable on demand or otherwise and withdrawable by cheque, order or otherwise.

Industry and trade, apart from credit, require professional help from experts in forming companies, in selecting projects, in arranging funds from various sources, in drawing merger / amalgamation schemes and a host of such other services / activities. **A merchant banker is one who provides such non-credit inputs to the trade and industry - of-course at a price!**

From the host of services / activities provided by a merchant banker, one can easily comprehend the important roles played by the merchant banker. Without a merchant banker in the driving seat, it would be next to impossible to select and form a project, set up the same, arrange for finance and profitably run it.

A merchant banker provides a wide range of merchant banking services. They are:

- **Assistance in the formation of companies**

Merchant banker would draft the memorandum of association and articles of association and assist in incorporation of the companies

- **Project counseling / evaluation**

Merchant banker would study the technical, financial, commercial viability of a project and would help in selection of consultants for preparation of detailed project reports. He / she would also arrange for obtaining various clearances from the government departments and organisations. In addition, he / she would also structure the means of finance.

- **Credit syndication**

Merchant banker would liaison with and selects the prospective banks and financial institutions to participate in financing the project. He / she would arrange the leader bank and finalise the sharing pattern of the total credit needs amongst the consortium members and would strike the best bargain for interest and other terms of finance and liaison till the documentation and disbursement of the financial arrangement are over.

- **Private placement**

Merchant banker would arrange private placement of shares and debentures with mutual funds, financial institutions and others

- **Issue management**

Merchant banker would manage public issues or arrange other merchant bankers to manage the issues. A merchant banker can be a lead manager, co manager, consultant to the issue. He / she would also select the lead manager, bankers, brokers, registrars, advertisers, printers to the issue. Another important role played by a merchant banker in the issue management is pricing the issue, i.e. fixation of premium. He / she would prepare the prospects and get clearances from Securities Exchange Board of India, Stock Exchanges, etc.

- **Underwriting**

Merchant banker would arrange for underwrite the issue or arrange underwriting from other merchant bankers.

- **Arranging other sources of finance**

Merchant banker would arrange for bridge finance for a company / unit, in case of delay in disbursement of term loans or in launching issues.

Merchant banker can be approached for arranging deferred payment guarantee from banks in favour of suppliers of machinery on deferred payment terms.

Merchant banker can also be requested to select lease companies for obtaining machineries / assets on lease.

- **Amalgamation and merger**

Merchant bankers help in drawing amalgamation and merger schemes. They also assist in obtaining different permissions for this purpose

- **Drawing rehabilitation schemes for sick units**
- **Portfolio management / advisory services**

Merchant banker would help in investing customer's funds in different stocks and securities and manage the same as per agreed terms and conditions for securing better return for the client.

GROWTH OF MERCHANT BANKING IN INDIA

By granting a license to Grindlays Bank in 1967, Reserve Bank of India activated merchant banking services in India. Grindlays Bank started with management of capital issues. It provided management consultancy services to large and medium sized companies, apart from meeting the needs of small-scale industrial units. Citibank NA started its merchant banking unit in 1970 to assist new entrepreneurs and established units in project evaluation and sourcing of funds through borrowing and issue of shares.

Other Indian banks also started merchant banking activities, consequent to the recommendations of the Banking Commission in 1972. Prominent among them were State Bank of India, Bank of India, Syndicate Bank, Indian Overseas Bank, Bank of Baroda, Standard Chartered Bank, Canara Bank, Punjab National Bank, to name a few.

Financial institutions like ICICI, IDBI and IFCI also set up their merchant banking divisions to provide service to trade and industry.

In India, merchant banking services are governed / regulated by

- Guidelines of Securities Exchange Board of India
- Guidelines of Ministry of Finance
- Companies Act, 1956
- Listing guidelines of Stock Exchanges
- Securities Contracts (Regulation) Act, 1956

Securities and Exchange Board of India was established in 1988 as an interim body. It was converted into a statutory body with the adoption of Securities and Exchange Board of India Act in 1992. SEBI is a body corporate with head office in Mumbai. It has one chairman and five other members.

The main objectives of the Board are to protect the interest of investors (in securities), promote, develop and regulate the securities market.

SEBI regulates securities market by regulating the activities of all agencies connected with the functioning of capital market viz. merchant bankers, brokers, registrars, mutual funds, portfolio managers, etc.

All these agencies are statutorily required to get them registered with SEBI and adhere to the rules and regulations of registration and code of conduct issued by SEBI.

To promote a healthy capital market, SEBI can form regulations to prevent insider trading (i.e. getting access to sensitive information for gain through sale / buy of shares of these companies) and illegal take over bids (i.e. acquisition of companies by acquiring / purchasing) shares without the consent / knowledge of the existing management.

Though control by way of prior approval is abolished making companies free to fix the size and price of issue, prudential control is exercised by SEBI by providing for disclosure norms while issuing capital to public.

The offer documents (i.e. prospectus in case of public issue and letter of offer for rights issue) through which the company invites capital must be prepared as per SEBI guidelines and must contain full disclosures as required by SEBI

All issues must be managed by an authorised merchant banker

The merchant banker will not only help in preparation of prospectus, he / she will also be required to verify with due diligence the facts given in the prospectus. He / she has to submit a due diligence certificate to SEBI for having properly verified the contents of the prospectus and to the effect that all disclosure norms are met.

NATIONAL STOCK EXCHANGE

INTRODUCTION

The frequent closure of Bombay Stock Exchange and the resultant suffering to genuine investors prompted the Central Government to have a separate stock exchange at the national level. It asked the Industrial Development Bank of India to take the lead and act as the nodal agency for starting the National Stock Exchange - NSE

FORMATION

National Stock Exchange of India Ltd was incorporated as a company on 27th November 1992. The capital of the company is contributed by Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India Ltd (ICICI), Industrial Finance Corporation of India (IFCI), General Insurance Corporation (GIC), Life Insurance Corporation of India (LIC), Stock Holding Corporation of India (SHCI), State Bank of India (SBI) and State Bank of India Capital Markets (SBI CAP).

National Stock Exchange has been granted recognition by the Central Government with effect from April 26, 1993 for a period of five years initially and subsequently renewed for further period.

The exchange is managed by a board of directors.

OBJECTIVES

The National Stock Exchange will enable the investors to buy or sell shares and securities from any part of India. Like OTCEI, it will provide ON LINE, COMPUTERISED, SCREEN BASED, SCRIPLESS trading with SHORT SETTLEMENT CYCLE.

OPERATION METHODOLOGY

NSE Mainframe: The main computer in Mumbai will be the centre for the countrywide market. It will give quotation for buying and selling scripts; broadcast price information and will generate data on deals for settlement between member brokers.

NSE-Brokers: NSE will appoint members, throughout the country. These members who will be provided with terminals can directly contact the mainframe through satellite or telephone lines. They can buy or sell shares electronically as per the automatic quotation system.

National Clearing House: The National Clearing House will receive data from National Stock Exchange and will determine the number of scripts to be transferred to / from the account of different investors. There will be no physical delivery of scripts as they will be stored with Stock Holding Corporation of India or with any other depository.

National Settlement System (NSS): The deals concluded by the members will come to the National Settlement System computers after the trading hours. The NSS will inform every day the members the net payment or receipt they have to make / receive. The settlement will be done once in every five days.

National Stock Exchange is regulated by Securities Exchange Board of India. It started its operations in January 1994, by trading in debt instruments, particularly government securities and public sector bonds.

OVER THE COUNTER EXCHANGE OF INDIA - OTCEI

CONSTITUTION

OTCEI which is a different kind of stock exchange became operational from March 1992. It is registered as a company under Section 25 (non-profit making) of the Indian Companies Act with its registered office in Mumbai.

It is promoted by eight institutions namely ICICI, IDBI, IFCI, LIC, GIC, UTI, SBI CAP and CANFINA.

OBJECTIVE

As regular stock exchanges do not generally list shares of companies with equity capital requirement of less than Rs.300 crores, OTCEI was formed to help small and medium companies to raise capital from public.

To help venture capital companies to raise capital, as these companies are not patronised by public in the initial stages.

To reduce cost of public issue which is becoming costlier, day by day.

To introduce a computerised, ringless, scripless and efficient share trading system in the country.

LISTING

Companies with equity capital of minimum Rs.30 lakhs and maximum Rs.25 crores are eligible to list their shares in OTCEI. A company is not permitted to list its shares in both OTCEI and regular stock exchanges.

FERA companies may list their shares in OTCEI, if they satisfy listing guidelines of any other recognised stock exchanges.

Companies engaged in leasing, hire purchase, finance, investment, amusement parks are not eligible for listing in OTCEI.

MEMBERS OF OTCEI

OTCEI has appointed members who are public financial institutions, scheduled banks, mutual funds, merchant bankers and venture capital funds. A company in order to list its shares must first approach one of these members, who are also called sponsors.

The sponsor has to certify the viability of the project and should recommend the enlistment. It should manage the issue of capital. Further it must act as a market maker (buy and sell scripts from / to public) for a minimum period of three years from the date of commencement of trading.

COUNTERS AND NETWORK

Apart from members, OTCEI has appointed many dealers in all big cities. These dealers and members provide counters for trading scrips. All these counters are provided with OTC Screen (to exhibit latest quotation) and computers and are connected by a national network. Trading takes place over the counters spread all over the country.

TRADING OPERATIONS AND COUNTER RECEIPT

An investor intending to buy / sell scrips listed in OTCEI should approach an OTCEI counter and get himself registered. The counter will issue on "Invest OTC" Card which is to be used for all transactions and applications for OTC issues. This card bears a code, which can be operated only by the investor and thereby provides safety and security of operation.

He can see the quotations in OTC Screen (PTI Scan Screen) displayed at every OTC Counter before deciding to buy or sell a scrip.

When he buys a scrip, the counter will give a "counter receipt". As it is a scripless system the share certificate will not be handed over to the buyer. it will remain in safe custody with a custodian (depository) who is normally the registrar to the issue. The counter receipt becomes a tradable document and is used for transfer of shares.

Where the buyer of the scrip wants to transfer the shares in his name, he can send the counter receipt along with the transfer deed to the registrar, who effects the transfer and continues to hold the share on behalf of the buyer.

OTCEI follows the model of NASDAQ (National Association of Securities Dealers Automated Quotations in USA) which is the largest market in the world.

PROJECT RELATED ACTIVITIES OF A MERCHANT BANKER:

The merchant broker would provide the following services in respect of project related activities:

- studying technical, financial, commercial viability of a project

TECHNICAL FEASIBILITY:

Study of technical feasibility involves the study of all aspects relevant to production of finished goods of proper quality. Points studied under this head are as hereunder:

- licences, permits required to start the project and their availability
- location of the project vis a vis the availability of raw material, utilities (power, steam, water, fuel, etc) and transport
- product and process : The manufacturing process adopted, vis a vis the modern technology available and the standing of the supplier of technology and his stake (as collaborator, share holder, etc) is to be examined. Wherever feasible, performance guarantee may be insisted upon from the suppliers of technology.
- plant and machinery: Suitability, capacity, standing of suppliers, availability of performance guarantee and cost etc are to be examined
- raw material and labour availability: quality, cost, regularity in supply are to be studied

FINANCIAL VIABILITY:

Study of financial viability involves the study of the following aspects.

- whether sufficient finance at reasonable cost is available to execute the project (cost of project and means of finance)

- whether sufficient profit will be available to service the creditors and share holders, (projected profitability statement and funds flow statement would be perused)

- whether sufficient funds / cash will be available to repay term loan instalment (debt service coverage ratio and projected cash flow)

- whether the break - even - point and margin of safety are satisfactory

- what will be the position of the company in future years (study of projected balance sheets for the years covering the currency of term loan).

COMMERCIAL VIABILITY:

The merchant banker would examine whether the goods can be sold in quantity and price as projected by entrepreneur. Unless the products are sold at or near to the projected level the expected cash flow will suffer and the unit would become sick. To avoid such an eventuality, a thorough examination would be made on the following aspects.

- the present and futuristic trend of demand for the product

- the level of competition from similar products and substitutes and the strength of the competitors

- the capability of the unit to penetrate the market (by aggressive / innovative marketing strategy) to gain and retain a comfortable market share

- the present stage in the life cycle of the product

- price of the product vis a vis the substitutes and the price elasticity of demand

CORPORATE COUNSELLING:

A merchant banker would provide under corporate counselling the following suggestions.

- **STRATEGIC DECISION MAKING FRAMEWORK**

Strategy is a central theme, which establishes an effective and efficient match between the company's competence and opportunities and risks created by environmental changes. It is a link between the multiple goals and objectives pursued by the firm to satisfy its various constituents and the plans and policies used by it to guide its daily operations.

- **FINANCIAL POLICY AND STRATEGIC MANAGEMENT**

Under financial management, two aspects - allocation of funds (investment decision) and generation of funds (financial decisions) are important. The objective of any firm is to maximise the wealth of its shareholders. The shareholders being the ultimate owners of the firm and therefore the financial manager should make decisions that will increase the value of the shareholders' stake in the firm.

- **STRATEGIC ASPECTS OF INVESTMENT POLICY**

The investment policy would be focused on strategic issues. Projects would be identified, developed and evaluated in a total strategic perspective instead of piece-meal approach. In that investment decisions would focus on the corporate objectives and organisational fit and raise pertinent strategic issues.

- **STRATEGIC FINANCING POLICY**

Whether to raise finance through debt financing or internal financing would be a crucial aspect, managers would be constantly considering and evaluating.

- **BALANCING FINANCIAL GOALS**

Financial goals are the quantitative expressions of a company's mission and strategy, and are set by its long-term planning system as a trade-off among conflicting and competing interests. Companies are not always governed by the maximum profit criterion. In practice, financial priorities change according to the

1722 changes in the economic and competitive environment. Managing a company's financial goals system is a continuous process of balancing different priorities in a manner that the demand for and supply of funds is reconciled.

PROBLEM AREAS OF AN ENTERPRISE

LOCATION

The proposed location of the enterprise may not be economically close to raw-materials, labour and services. Highways, rivers, railroads and truck transportation facilities may not be available.

PHYSICAL AND NATURAL RESOURCES INVOLVED

The raw materials may be requiring special treatment and for this facility may not be available. Adequate electric power supply and required wattage may not be available. Fuel may be another constraint. Good quality and potable water may not be available for processing, sanitation and for human consumption. Even if these are available, they may not be available at an economically cheaper cost in necessary quantities and qualities.

RAW MATERIALS

Such materials must be considered as the major hurdle as non-availability of one can negate a project. The following questions therefore naturally arise

- what raw materials are needed and in what quantities ?
- does delivery schedule call for advance procurement or stock-piling ?
- is proper storage provided for such inventory ?
- is the cost of indigenous raw materials higher than imported raw materials
- how does the quality of indigenous materials compare to imported material ?
- will the project requirements promote expansion of raw materials production?
- is adequate use of indigenous raw materials indicated ?

- is there an excess of unjustifiable use of imported raw materials with attendant exposures?

PRESENT STATE OF THE INDUSTRY

The industry as a whole may be declining and obsolescence setting in through failure to advance in technology of processing and equipment. Also the market may be shrinking in size due to substitution of raw materials or better products.

MACHINERY AND EQUIPMENT

The machinery and equipment may not be modern, available and capable of economically producing the required output. The answers to the following questions will reveal the extent of problem

- is the machinery and equipment obsolete or near obsolete from age, use or technological points ?
- will the proposed equipment produce the quality and quantity of product desired at a competitive price ?
- has provision been made for adequate spare parts ?
- is the plant and plant lay out designed for possible expansion ?
- is the machinery fairly priced for current and scheduled procurement time ?
- is the cost of installation included as a machinery and equipment cost ?
- has provision been made for adequate maintenance ?
- has the lead time for acquiring and installing the machines and equipment been considered ?

PROJECTED TIME FOR IMPLEMENTATION

Scheduled time for implementation and maximum capacity may not have been properly worked out and judged to avoid confusion and misapplication of funds

COSTS

All known and expected future costs may not have been considered to the extent possible so that proper allocation of funds could be made. The following questions might have been omitted in the consideration.

- are all known or projected costs indicated ?
- are these costs reasonable ?
- are there any concealed costs, particularly those concerned with scarce or limited materials and resources ?
- has the cost of installation of machines, equipment and services been included and shown separately ?
- have material costs been compared ?
- have building and rental costs been considered and found reasonable ?

AVAILABILITY OF RESOURCES

The availability of resources affects the economics of a project to the point where it could be the major deciding factor as to acceptance and implementation of a project. Therefore, the following pose major questions in the problem areas of a project

- are raw materials available in quantity and quality necessary near the project site?
- are all services currently available in quantity and type necessary ?

- is there sufficient water available near the project location ?
- will it be necessary to install systems for water, light or power ?
- how will the raw materials be obtained and delivered ?

EXPECTED PRODUCTS

The expected products should be described as specifically as possible to determine if machines, equipment and processes will produce them in quantities and quality stated.

PLANT CAPACITY

Care must be taken to determine that the plant is capable of producing the estimated production within the forecast time.

MARKET

Before project investment is programmed for implementation the potential absorption of the products must be known.

MANPOWER

Without available management, technical and skilled labour a project is practically doomed from its inception

SOCIAL IMPLICATION

All development projects have social implications and tend to add to or detract from existing social conditions

TRANSPORTATION

Too many projects are proposed for locations where they cannot exist economically and technically because of the lack of or high cost of adequate transportation

MARKETING

Without a plan or programme for marketing the products a project can only succeed in paper or by accident

RELATIONSHIP TO SAME INDUSTRY

A project may provide needed competition to invigorate an existing industry, fill a lack of capacity, or provide a support function to other producers, in the same industry

RELATIONSHIP TO OTHER INDUSTRIES

No industry stands alone. Each depends on one or more other industries for material, machine, service or distribution and marketing support

RELATIONSHIP TO THE NATIONAL ECONOMY

If an individual project fails to indicate a positive contribution to the national income it is almost positive to result in a reduction of the national income

SPECIAL PROBLEMS

Such problems may be of social, physical, resource, location, or other nature which have a peculiar and important effect on a specific project or group of projects

An example of this could be a project proposed for glass manufacture. This project would require continuous supply of large quantities of potable water. The water situation does not lend itself normally to the fulfillment of such a requirement. Therefore, this becomes automatically a special problem of supply and cost.

LOAN SYNDICATION

MEANING

In syndication, a bank generally called the lead bank or syndicator arranges a group of banks to form a syndicate and this syndicate provides credit facility to the borrower using a common loan documentation.

Probably, a particular bank may not be in a position to meet the entire credit needs of borrower - either from the point of view of availability of funds, regulatory requirements with regard to lending to a single borrower or group of borrower, exposure consideration to a particular industry, etc. In these circumstances, loan syndications can be worked out to match and meet the requirements of the banker and borrower.

Usually in a syndicated loan, there are five parties, namely, borrower, lead manager or syndicator (the bank which arranges the syndicate), participating banks (banks/investors who provide funds and participate in syndicate), agent bank (bank which monitors the disbursements, end use and repayment of the loan) and guarantor (who guarantees banks/investors the loan to the borrower.

STEPS IN SYNDICATION

Step 1: Invitation for bids: The borrowing company in need of the loan, approaches different banks willing to act as lead manager for syndicating the loan and invites bids from them. It provides the necessary details about the loan like the amount of funds required, the purpose and period for which it is required and other terms and conditions.

Step 2: Preliminary survey by the lead managers: On receipt of the query, a syndicator scouts for the banks who may be willing to join the syndicate and tries to find out members who quote the best price. Based on this survey it submits offer letter for the bid.

Step 3: Offer letter: The offer letter submitted by the bank contains the broad terms of the loan. Some of these conditions are -

i. amount of the loan,

ii. purpose and period of the loan,

iii. drawn down period - the period during which the loan should be drawn failing which the amount remaining undrawn would be automatically cancelled,

iv. rate of interest - a fixed rate or floating rate,

v. commitment charges - the amount payable by the borrower on the amount of loan remaining undrawn (i.e.unutilised portion),

vi. management fees - fee payable to the lead manager / syndicator for arranging the syndicate and managing the loan till the stage of documentation,

vii. agency fees - fees payable to the bank who acts as the agent of the syndicate and monitors the loan after the documentation is over,

viii. repayment programme,

ix. security,

x. guarantor,

xi. documentation,

xii. expiry date of the offer.

Step 4: Awarding of mandate: After examining the bids from various banks, the borrower awards the mandate to the bank that offers him the best terms. Apart from the terms the borrower also evaluates the capability of the bank to arrange the deal within the specified time, which in turn depends upon the track record of the bank. The bank which is given the mandate to syndicate the loan is called the mandated bank or lead manager. The borrower issues a mandate letter (usually by

signing the duplicate copy of the offer letter) designating the bank as lead manager

Step 5: Signing of clear market clause letter: After awarding the mandate, the borrower has to sign a clear market clause letter undertaking not to seek a syndicated loan from any other source during the intervening period before the execution of documents

Step 6: Forming lead management group: After obtaining the mandate the lead manager may form a lead management group along with other banks, to take up the lead manager job as a group

Step 7: Offer telex: The lead manager (or the lead management group) then sends offer telexes to prospective lenders on a broad case basis or on a selective basis. The offer telex gives the salient features of the loan and specifies the date within which the banks can accept the offer. In case the borrowing company is well known and the terms of the loan are uncomplicated and the market is liquid the offer telex itself is sufficient to market the loan

Step 8: Information memorandum / offer documents: This document is similar to a prospectus but is less detailed. It contains material information on the borrowing company and viability of the project (like history, background, financial projection, market studies on borrower's product, etc). It is sent after the offer telex. The information memorandum seeks to provide sufficient factual information, which will enable a bank to take a credit decision. This memorandum normally contains a disclaimer clause by the lead manager disowning responsibility for the accuracy or completeness of the information contained therein. It also emphasises that reading the memorandum is no substitute for an independent credit appraisal by the participating banks

Step 9: Receipt of confirmation from banks: Once the commitment from banks is received upto the required amount the major portion of the syndication task is over and then the lead manager arranges for documentation

Step 10: Documentation: The following documents are generally obtained in case of syndication advance -

i. basic loan agreement containing - description and identification of all parties to the syndicate, purpose clause, repayment/prepayment clause, interest rate/interest payment clause, covenants clause, agency clause, security clause

ii. promissory note

iii. inter-se agreement among participating banks

iv. guarantee agreement from guarantors

v. credit support instrument signed by parent company

Step 11: Signing ceremony: Once the documents are prepared in consultation with the advocate, all parties to the syndication viz. borrower, guarantor, lead manager, participating banks assemble in one place to sign documents. Participating banks who are unable to attend the signing ceremony authorise their attorneys (usually the lead manager) to execute documents on their behalf.

Step 12: Appointment of agent bank and its role - an agent bank is the bank who is appointed by the syndicate to administer the loan throughout its life on behalf of the syndicate of banks.

CAPITAL ISSUE RELATED ACTIVITIES OF A MERCHANT BANKER

A merchant banker can undertake any one or more the following roles in capital issues:

- Lead Manager to the issue
- Manager / Co-Manager / Joint Manager to the issue
- Advisor / Consultant to the issue

Apart from these roles, a banker can also be appointed as Bankers to the issue or refund banker to the issue.

SEBI has stipulated that capital issues should be managed by Lead Managers only. Companies can appoint one or more lead managers to the issue. The maximum number of lead managers to be appointed it's restricted to the size of the issue, as given below:

Size of the issue	Maximum Number of Lead Managers
Upto Rs.50 crores	Two
Above Rs.50 crores and upto Rs.100 crores	Three
Above Rs.100 crores and upto Rs.200 crores	Four
Above Rs.200 crores and upto Rs.400 crores	Five
Above Rs.400 crores	To be decided by SEBI

Functions of Lead Managers:

- Lead Managers to exercise due diligence in verifying the prospectus / letter of offer

- It has to submit final draft prospectus alongwith its Due Diligence Certificate to SEBI atleast 15 days before filing the prospectus with Registrar of Companies

- When there are more than one Lead Manger, an interse allocation of responsibilities as agreed by lead managers must be submitted to SEBI alongwith prospectus as above

- Lead Managers to compulsorily underwrite atleast 5% of the issue

- Lead Manager is responsible for ensuring timely refund of excess application money or mailing of share / debenture certificate

- Lead Managers are to ensure the collection of amount from underwriters in case of devolvement

Fees for Manager / Lead Manager

The lead managers are freed to negotiate the management fee with the issuer company

Banker to the issue

As per Sec 73 (3) of Companies Act 1956, all application money received must be kept in a separate bank account maintained with a scheduled bank the proceeds of which are to be utilised towards adjustment against allotment of shares or refund of application money.

Further as per listing regulations of stock exchanges a company must make necessary arrangements for acceptance of money at prescribed number of collection centres which must include all places where stock exchanges have been established.

For the above two reasons, the company appoints Bankers to the issue to collect money relating to the issue at all required centres.

The banks acting as bankers to the issue enjoy float funds, deposits and of course good will from the public.

Brokers to the issue

Brokers (who are members of Stock Exchanges), Merchant Bankers and Financial Institutions whose stamp appears as brokers on successful applications are paid brokerage.

Underwriters to the issue

Underwriting means guaranteeing procurement of agreed number of shares and agreeing to subscribe for the shortfall if any.

As per SEBI guidelines the full issue offered to the public must be underwritten.

Underwriting can be undertaken by merchant bankers, financial institutions, investment companies and trusts. No person can act as underwriter without obtaining a certificate of registration from SEBI.

Brokers who are members of stock exchanges can with prior permission from their respective stock exchanges underwrite maximum upto 5% of the issue.

The minimum networth of an underwriter should be Rs.20 lakhs.

The aggregate outstanding commitment of a merchant banker on account of underwriting should not exceed 20 times its networth at any point of time.

Lead managers must underwrite minimum to the extent of 5% of the issue.

CHANGING STRUCTURE OF INDIAN CAPITAL MARKET:

India has a well defined capital market system, by far one of the best in the developing world.

The capital market works in the given economic industrial milieu. Indian economy for over three decades after independence was dominated by the public sector, which was considered as the major vehicle for economic and industrial development. The trend has, however, changed since the mid-80s with liberalisation of Government policies and greater freedom given to the private sector in most of the sectors, including the basic sector comprising iron and steel, power and road construction among others. The policy of progressively deregulating the economy has more than else led to the emergence of stock markets as a major instrument of finance for trade and industry.

The first stock exchange came to be established in 1875 in Mumbai (then Bombay) when the stock brokers, aghast at the plight following the severe depression in securities industry, decided to form an association for protecting the character, status and interest of native share and stock brokers and of providing a hall or building for the use of the members of such an association. The process of establishment of stock exchanges gradually spread to other cities of the country like Ahmedabad, Calcutta, Madras (now Chennai) etc.By the time Securities Contracts (Regulation) Act 1956 came into force, there were eight recognised stock exchanges in the country. The decade of eighties saw, the birth of a number of new recognised stock exchanges in the country and Cochin in the south, Gauhati in the east and Rajkot in the west. With the cult of equity spreading fast to the four corners of the country, prospects of many more stock exchanges springing up in the country are very bright. The argument by a section that establishment of more stock exchanges is not conducive for the development of efficient systems of functioning of the securities industry ignores the fact that the communication facilities in the country are not satisfactory and also that a direct and close regulating authority easily accessible to the investors inspires the confidence in investors in stock market instruments.

The growth in the numbers of direct shareholders in the country has also been phenomenal during the last one decade. It has grown steadily from about a million or so about ten years ago to about fifteen million currently. The country has thus the second largest shareholder population in the world next only to the United States of America which has about fifty million shareholders and

subscribers to mutual funds and significantly ahead of countries like Japan, UK and France, all with a population of about ten million.

The country has also a large number of debenture holders whose figure can currently be estimated to be about seven million. These also add to the stock market activity. Most of the debenture holders are prospective shareholders as they hold convertible debentures awaiting conversion into equity shares. Non-convertible debenture holders are not very popular in India as the rate of interest is pegged generally at the maximum rate of interest. The concept of a freely floating rate of interest on debentures is still not well accepted in this country, although a very few companies have floated such debentures.

The relatively less stringent conditions have led to emergence of a large number of listed companies in the country. Here again, India occupies the second position in the world next only to the United States of America.

The turnover in the Indian stock exchanges has zoomed to greater heights during the last fifteen years. What is more exciting about the Indian stock markets is the number of deals put through in a day.

Indian stock markets wore a lackluster outlook till the decade of eighties basically because equities failed to act as a hedge against inflation while other avenues of investment like Gold, Silver, real estate, etc. proved to be safe havens against the rising prices. During the sixties the index of number of ordinary shares, as compiled by Reserve Bank of India, rose by a meagre two per cent while in the seventies the rise was more modest being of the order of about 60 per cent while the rise in the index number of wholesale prices during these two decades was of the order of about 80 per cent and 160 percent respectively. The decade of eighties witnessed the rise in the Reserve Bank of India index of ordinary shares shooting by over 250 per cent while the wholesale price index rose by about 75 per cent during the same period. The year 1990 saw a further spectacular advance in equity shares of being almost doubled up despite a mild setback. In the area of market capitalisation also, Indian stock markets have performed well and the present level constitutes as much as 25 per cent of the gross national product.

There are no net capital requirements in the Indian stock markets, linking up the volume of business of a company with its funds as in the developed markets of the world. Yet a system of checks and balances have been evolved over a period of time which not only tend to control and regulate the volume of business of individual firms but also of the market as a whole. These are mainly confined to specified shares as the speculative pressures are normally concentrated in this group. The principal instruments employed are – margin, limiting the movement of prices, limiting the outstanding business than can be carried forward, limiting the extent of jobbing by a member. In addition, whenever the outstanding volume of business in any particular scrip exceeds a particular level considered to be dangerous, which normally is five per cent of the permitted only on a spot delivery basis i.e. for delivery and payment on the same day or on the day following the day of contract. Normal trading is permitted to be resumed only after the outstanding business gets reduced to a reasonable level. On critical occasions, even the outstanding business in a scrip is ordered to be liquidated by certain percentage points, say by 15 or so, in every settlement. Speculative transactions i.e. transactions that do not result in delivery, popularly known as short sales and long purchases, are prohibited. The above measures are designed not only to keep the speculative excesses under check but also to regulate the movement of prices. As a result, the Indian stock markets have displayed a remarkable degree of poise and stability.

A major development in the Indian stock market, which deserves special mention, is the establishment of Securities and Exchange Board of India. SEBI has been given a legal status, as a supervisory body in 1992. It is required to regulate and promote the securities market by:

- providing fair dealings by the issue of securities and ensuring a market place where funds can be raised at a relatively low cost
- providing a degree of protection to the investors and safeguard their rights and interests so that there is a steady flow of savings into the market
- regulating and developing a code of conduct and fair practices by intermediaries in the capital market like brokers and merchant bankers with a view to making them competitive and professional.

TYPES AND CHARACTERISTICS OF CORPORATE SECURITIES

A company has to assemble funds from numerous sources to satisfy varied financial needs of the company. A company requires long term funds to acquire fixed assets and other infrastructure and to carry certain permanent portion of current assets to ensure uninterrupted and smooth flow of production and business activity. It may also need short term funds to meet day to day needs and medium term capital, for financing aggressive positioning and for complete overhauling of its machines and equipments.

The company has to employ such means and mechanism by means of which he can garner the desired resources from investing community. The securities issued by the company represent claims on a stream of income and / or particular assets. Such important, popular corporate securities are:

Equity Shares or ordinary shares:

Equity or ordinary shareholders or stockholders are the legal owners of the issuing company. These shares are the source of permanent capital since they do not have a maturity date. For the capital contributed by the shareholders by acquiring the shares, they are entitled for the dividends, which is not fixed. Therefore, the equity or ordinary share is also known as variable income security. Being the owners of the company, shareholders run the risk of ownership; therefore they have a say in the composition of the management team which run the company on a day to day basis. This is exercised through their voting rights that go with the equity or ordinary shares. They are entitled to dividends after the claims of others have been settled and satisfied. Similarly, when the company is wound up, after meeting the claims of other suppliers of capital of the company is met, the balance is distributed among the equity or ordinary share holders.

The characteristics of equity or ordinary shares are as under:

- Claim on income - ordinary share holders have residual claim on ownership
- Claim on assets

- Right to control – control in the context of a company means power to determine its policies. The company's major policies and decisions are approved by the board of directors while day to day operations are carried out by managers appointed by the board. Thus control may be defined as the power to appoint directors. Ordinary shareholders have the legal power to elect directors on the board. If the board fails to protect their interests, they can replace directors. Ordinary shares are able to control management of the company through their voting rights and right to maintain proportionate ownership.

- Voting rights – the equity or ordinary shareholders are required to vote on a number of important matters. The most significant proposals include: election of directors and change in the memorandum of association. Each ordinary share carries one vote. Thus an ordinary shareholder has votes equal to the number of shares held by him / her.

- Pre-emptive rights – the pre-emptive right entitles a shareholder to maintain his proportionate share of ownership in the company. The law grants shareholders the right to purchase new shares in the same proportion as their current ownership. A shareholder may decline to exercise this right. The shareholders' option to purchase a stated number of new shares at a specified price during a given period is called "right" These rights can be exercised at a subscription price which is generally much below the share's current market price, or they can be allowed to expire, or they can be sold in the market.

- Limited liability – equity shareholders are the true owners of the company, but their liability is limited to the amount of their investment in shares. If a shareholder has fully paid the issue price of shares purchased, he has nothing more to contribute in the event of a financial distress or liquidation. This position of shareholders is different from the owners in the case of sole proprietary business or partnership firms where they have unlimited liability. The limited liability feature of equity share encourages otherwise unwilling investors to invest their funds in the company.

Pros & cons of equity funding

- Permanent capital
- Borrowing base
- Dividend payment discretion

Disadvantages

- Cost
- Risk
- Earnings dilution
- Ownership dilution

Equity or ordinary shares can be acquired through anyone of the following routes:

- Public issue – public issue of equity shares mean raising of share capital directly from the public.
- Private Placement – private placement involves the sale of shares by a company to few selected investors, particularly the institutional investors. Private placement has certain advantages – helpful to raise small amounts, less expensive, less time in raising funds.
- Underwriting – it is legally obligatory to underwrite a public and a rights issue. In an underwriting, the underwriters – generally brokers, banks and financial institutions – guarantee to buy the shares if the issue is not fully subscribed by the public.
- Rights – a rights issue involves selling of ordinary shares to the existing shareholders of the company. The law in our country requires that the new ordinary shares must be first issued to the existing shareholders on a pro rata basis. This pre-emptive right can be forfeited by the shareholders through a special resolution.

Preference Shares:

Preference share is often considered to be a hybrid security since it has many features of both ordinary shares and debentures. It is similar to ordinary share – the nonpayment of dividends does not force the company to insolvency, dividends are not deductible for tax purposes, in some cases, it has no fixed maturity date. On the otherhand, it is similar to debentures – dividend rate is fixed, preference shareholders do not share in the residual earnings, preference shareholders have claims on income and assets prior to common shareholders and they usually do not have voting rights.

The characteristics of preference shares are:

- Claims on income and assets
- Fixed dividend
- Cumulative dividend – Most preference shares in our country carry a cumulative dividend feature, requiring that all past unpaid preference dividend be paid before any ordinary dividends are paid. This feature is a protective device for preference shareholders.
- Redemption
- Sinking fund – like in the case of debentures, a sinking fund provision can be created to redeem preference shares. The money set aside for this purpose may be used either to purchase preference share in the open market or to buy back (call) the preference share.
- Call features – the call feature permits the company to buy back preference share at a stipulated buy-back or call price. Call price may be higher than the par value. Usually it decreases with the passage of time. The difference between call price and par value of the preference share is called call premium.

- Participation – preference shares may in some cases have participation feature, which entitles the preference share holders to participate in extraordinary profit earned by the company. This means that a preference shareholder may get dividend amount in excess of the fixed dividend.

- Voting rights – preference share holders ordinarily do not have any voting rights. They may be entitled to contingent (conditional) voting rights. In India, if a preference dividend is outstanding for two or more years in the case of cumulative preference shares or the preference dividend is outstanding for two or more consecutive preceding years or for a period of three or more years in the preceding six years, preference shareholders' can nominate a member on the board.

- Convertibility – preference shares may be convertible or non-convertible. A convertible preference share allows preference share allows preference shareholders to convert their preference shares, fully or partly, into ordinary shares at a specified price during a given period of time. Preference shares, particularly when the preference dividend rate is low, may sometimes be converted into debentures.

Preference share has a number of advantages to the company, which ultimately occur to ordinary shareholders.

Pros and cons

- Riskless leverage advantage – preference share provides financial leverage advantages since preference dividend is a fixed obligation. This advantage occurs without a serious risk of default. The non-payment of preference dividends does not force the company into insolvency.

- Dividend postponability – preference share provides financial flexibility to the company since it can postpone payment of dividend.

- Fixed dividend – the preference dividend payments are restricted to the stated amount. Thus preference shareholders do not participate in the excess profits as do the ordinary shareholders.

- Limited voting rights – preference shareholders do not have voting rights except in the case dividend arrears exist. Thus the control of ordinary shareholders is preserved.

Limitations

- Non deductibility of dividends – The primary disadvantage of preference share is that preference dividend is not tax deductible. Thus it is costlier than debenture.

- Commitment to pay dividend – although preference dividend can be omitted, they may have to be paid because of their cumulative nature. Non-payment of preference dividends can adversely affect the image of a company, since equity share holders cannot be paid any dividend unless preference shareholders are paid dividends.

Debentures

A debenture is a long term promissory note for raising loan capital. The company promises to pay interest and principal as stipulated. The purchasers of debentures are called debenture holders. An alternative form of debenture in India is bond. Bonds are issued mostly by the public sector companies in India. A debenture is a long term, fixed income, and financial security. Debenture holders are the creditors of the firm. The par value of a debenture is the face value appearing on the debenture certificate.

The characteristics of debentures are:

Interest rate – The interest rate on a debenture is fixed and known. It is called the contractual or coupon rate of interest. It indicates the percentage of the par value of the debenture that will be paid out annually or semi annually or quarterly in the form of interest.

Maturity – Debentures are issued for a specific period of time. The maturity of a debenture indicates the length of time until the company redeems the par value to debenture holder and terminates the debentures.

Redemption – Debentures are mostly redeemable; they are generally redeemed on maturity. A redemption of debentures can be accomplished either through a sinking fund or buy-back (call) provision)

Sinking fund – As in the case of preference shares, a sinking fund in cash is set aside periodically for retiring debentures. The fund is under the control of trustees who redeem the debentures either by purchasing them in the market or calling them in an acceptable manner. In some cases, the company itself may handle the retirement of debentures using the sinking fund. The advantage is that the periodic retirement of debt through the sinking funds reduces the amount required to redeem the remaining debt at maturity. Particularly when the company faces temporary financial difficulty at the time of debt maturity, the repayment of huge amount of principal could endanger the company's financial viability. The use of the sinking fund eliminates this potential danger.

Buy-back or call provision – Debenture issues include buy-back provisions. Buy-back provisions enable the company to redeem debentures at a specified price before the maturity date. The buy-back (call) price may be more than the par value of the debenture. This difference is called call or buy-back premium.

Indenture – An indenture or debenture trust deed is a legal agreement between the company issuing debentures and the debenture trustee who represents the debenture holders. It is the responsibility of the trustee to protect the interests of debenture holders by ensuing that the company fulfils contractual obligations. Generally, a financial institution or a bank or a firm of attorneys is appointed as a trustee. The debenture trust deed provides the specific terms of the agreement, including a description of debentures, rights of debenture holders, rights of the issuing company and responsibilities of trustees.

Security – Debentures are either secured or unsecured. A secured debenture is secured by a lien on the company's specific assets. If the company defaults, the trustee can seize the security on behalf of the debenture holders. When debentures are not protected by any security, they are known as unsecured or naked debentures. If the debentures are unsecured, it will generally be difficult for the company to attract investors to subscribe to them. Security, however, does

not necessarily ensure the safety of a debenture / bond from the investor's point of view. Debentures are rated by professional bodies to indicate the degree of their safety. Credit rating of a debenture shows the chances of timely payment of interest and principal by a borrower.

Yield – The yield on a debenture is related to its market price; therefore, it could be different from the coupon rate of interest.

Claims on assets and income – Debenture holders have a claim on the company's earnings prior to that of the shareholders. Debenture interest has to be paid before paying any dividends to preference and ordinary shareholders.

Types of debentures: Debentures may be straight debentures or convertible debentures. A convertible debenture (CD) is one which can be converted, either fully or party, into shares after a specified period of time. Thus, debentures may be classified into three categories – non-convertible debentures (NCD), fully convertible debentures (FCD) and party convertible debentures (PCD)

In the case of convertible debentures either fully or party, the following are the key issues:

- Conversion ratio and conversion price
- Valuation of convertible debentures

Why convertible debentures ?

- Sweetening fixed income securities
- Deferred equity financing
- Raising low cost capital

Pros and cons of debentures:

- Less costly – it involves less cost to the firm than the equity financing because investors consider debentures as a relatively less risky investment alternative and therefore, require a lower rate of return and interest payments are tax deductible.

- No ownership dilution – debenture holders do not have voting rights, therefore, debenture issue does not cause dilution of ownership.

- Fixed payment interest – debenture holders do not participate in extraordinary earnings of the company. Thus the payments are limited to interest.

- Reduced real obligation – during periods of high inflation, debenture issue benefits the company. Its obligation of paying interest and principal, which are, fixed decline in real terms.

Debentures have the following limitations also:

- Obligatory payments – debenture results in legal obligation of paying interest and principal, which, if not paid, can force the company into liquidation.

- Financial risk – it increases the firm's financial leverage, which may be particularly disadvantageous to those firms which have fluctuating sales and earnings.

- Cash outflows – debentures must be paid on maturity, and therefore, at some points, it involves substantial cash outflows.

- Restricted covenants – debenture indenture may contain restrictive covenants, which may limit the company's operating flexibility in future.

Commercial Papers

Commercial paper – CP – is an important money market instrument to raise short term funds. In India, on the recommendations of the Vaghul Working

Group, the Reserve Bank of India introduced the commercial paper scheme in the Indian money market in 1989. Commercial paper is a form of unsecured promissory note issued by the company to short-term funds. The buyers of commercial papers include banks, insurance companies, unit trusts and companies with surplus funds to invest for a shorter period with minimum of risk. Given this investment objective of the investor in the commercial paper market, there would exist demand for commercial papers of highly creditworthy companies.

As a major step towards disintermediation, Reserve Bank of India permitted from 1st April 1990, well rated corporate entities to raise their short term working capital requirements directly from the market by issuing commercial papers instead of depending solely on banks.

CPs are unsecured, usance promissory notes transferable by endorsement and delivery. They need to be stamped at the rate of duty applicable for usance promissory note.

To ensure orderly development of CP market and also to ensure investor protection, certain eligibility criteria have been prescribed for issue of CP.

In India, the cost of a CP will include the following components:

- Discount
- Rating charges
- Stamp duty
- Issuing and paying agent (IPA) charges

Merits and demerits

There are two important advantages of commercial paper from the issuing company's point of view:

- It is an alternative source of raising short-term finance, and proves to be handy during periods of tight bank credit

- It is a cheaper source of finance in comparison to the bank credit. Usually, interest yield on commercial paper is less than the prime rate of interest.

From the investor's point of view, it provides an opportunity to make a safe, short-term investment of surplus funds.

The following are the limitations of this source of financing:

- It is an impersonal method of financing. If a company is unable to redeem its paper due to financial difficulties, it may not be possible for it to get the maturity of the paper extended.

- It is available always to financially sound and highly rated companies. A company facing temporary liquidity problems may not be able to raise funds by issuing new paper.

- The amount of loanable funds available in the commercial paper market is limited to the amount of excess liquidity of the various purchasers of commercial paper

- It cannot be redeemed until maturity. Thus if a company no more needs the funds, it cannot repay until maturity and will have to incur interest costs.

Despite the above, the popularity of a commercial paper is due to:

- High liquidity in the money market
- Low cost of CPs in relation to other money market instruments and bank finance.

Bonds

Bonds serve as a kind of anchor to the winds of adversity. Normally investors look to bonds for certainty of income. Bonds tend to represent an important investment alternative in the asset allocation decision.

Bond returns are less than stock returns. However, bond investment involves less risk. This does not mean investor in bonds gets locked into the investment for a fairly long time. Bonds also have a place for an ever-increasing number of investors who do not wish to buy and hold. These investors are interested in capitalising on bond price movements. Bond trading can offer to these investors every bit of excitement normally associated with trading in stocks.

In many respects, bonds are equated with debentures in India. However, to the discernible, bonds do have certain specific characteristics different from the debentures.

Bonds can be classified into different types based on

- Coupon (interest)
- redemption terms
- currency

Coupon – interest on or earnings from the bond

- straight <u>or</u> plain vanila or bullet
- zero coupon
- variable rate <u>or</u> floating rate
- index linked
- income

Redemption terms – closing of bond investment

- single known date or straight
- range of possible dates - double dated
- callable - to be chosen by issuer
- puttable - to be chosen by investor
- never - perpetual, irredeemable, consoles
- convertibles

Currency - in which the bonds are issued or dealt with

- Domestic
  - i. if issuer domestic, domestic bonds (payments usually net of taxes)
  - ii. if issuer is foreign, bull dog, samurai, matador, etc (payments usually gross – income tax, capital gains tax are to be provided for)
- Foreign
  - i. eurobonds - shoguns (usually bearer forms)
  - ii. dual currency - coupon in currency x redemption in currency y
  - iii. currency change - coupons in currency x then in currency y
  - iv. fixed, then floating
  - v. floating, then zero

Warrants

Enables the purchaser to buy a fixed number of ordinary shares at a particular price during a specified period - warrants are generally issued alongwith debenture issue as sweeteners.

Characteristics of a warrant are

- Exercise price – The exercise price of a warrant is the price at which its holder can purchase the issuing company's shares.
- Exercise ratio – The exercise ratio states the number of ordinary shares that can be purchased at the exercise price per warrant. This is same as the conversion ratio in the case of the convertible securities.
- Redemption date – or Expiration date – The redemption date is the date when the option to buy ordinary shares in exchange for warrant expires.
- Detachability – A warrant can be either detachable or non-detachable. If a warrant can be sold separately from the debenture (or preference share) to which it was originally attached, it is called a detachable warrant. A debenture holder may sell his warrant when its price increases but continue holding the debenture. A non-detachable warrant cannot be sold separately from the debenture to which it was originally attached.
- Right – warrants entitle to purchase ordinary shares. Therefore, the holders of warrants are not the shareholders of the company until they exercise their options. Therefore, they do not have rights of ordinary shareholders, such as the right to vote or receive dividends. Once they exercise their warrants and buy ordinary shares, they become the company's ordinary shareholders.

Why warrants ?

Generally, three reasons are cited for issuing warrants.

- Sweetening debt – warrants help to make the issue of equity and debentures attractive. If the company is doubtful about the full subscription of the debenture issue, warrants are used to sweeten the issue by giving the investors an opportunity to participate in capital gains when the share price appreciates. A company may also offer relatively low interest rate to the investors if the warrants are attached to the debenture. It may be remembered that the convertible debentures perform the same function.

- Deferred equity financing – warrants provide a company an opportunity for deferred equity financing. The company sells its ordinary shares in future at a premium by setting exercise price higher than the prevailing share price. What is important, however, is the future share price. If the market price in future does not rise higher than the exercise price, investors may not exercise the warrants.

- Cash inflow in future – the company obtains cash when investors exercise their warrants. The warrant holder exchanges the warrant plus cash for the new ordinary shares.

Other advantages of warrants are also available:

- Issue of warrants keeps the share price high because it keeps equity at a lower level and thereby causes earnings per share to increase

- The investor is enabled to have access to the shares without investing the full amount in the share now. The issue of non-convertible debentures with attached warrants allows investor to strip the warrant and sell NCD at a very small discount. Thus his investment today is almost zero. He pays for share after some time in future.

- Issue of warrants enables promoters to increase their holdings. An issue of partly convertible debentures is almost same as an issue of NCDs with warrants attached. NCDs with warrants attached are not well understood by public. Therefore, they are undersubscribed. This helps the promoters to subscribe to NCDs with warrants attached by putting extra money and increase their holdings.

MANAGEMENT OF PRE-ISSUE ACTIVITIES

Public issues have become a core function of merchant bankers nowadays. The issue function can be mainly divided into pre-issue and post-issue management.

Investment of funds can be mobilised through primary market in the form of issue of securities, shares or debentures. Initial issues are issue of shares for the first time after incorporation or conversion from private limited to public limited company. Normally such initial offer can by issue of prospectus and invitation is extended to general public to subscribe to them. In the alternative, they can be made on a direct solicitation basis, by selectively approaching the potential investors

Important activities in any issue management are:

- Listing with stock exchanges – To submit memorandum and articles for approval of stock exchange – To prepare draft prospectus and to obtain comments on it from stock exchange – To prepare final draft prospectus and to get stock exchange's approval in writing for waiver of certain problematic statutory collection centres

- Submission of prospectus to SEBI – To submit the final draft prospectus to SEBI for vetting alongwith due diligence certificate, interse allocation of responsibilities and to get it approved. It is to be submitted atleast 15 days prior to filing of prospectus with Registrar of Companies.

- Filing of prospectus with ROC – Consent under Sec.60 of Companies Act is to be obtained from bankers to the issue, bankers to company, auditors, legal advisors, registrars to the issue, lead / co managers to the issue and then prospectus is to be filed with the Registrar of Companies after getting it duly signed by the Directors. Filing of prospectus with Registrar of Companies must be done not before 40 days of the release of prospectus to the public.

- Appointment of printers, advertisers and Registrar to the issue – Printers, advertisers and registrars of standing should be associated with the issue as these are very special jobs.

- Opening and closing of subscription list – Public issue should remain open atleast for three working days and maximum ten working days where the issue is underwritten or twenty one days if the issue is not underwritten.

- Coordination – In the management of pre-issue connected work a merchant banker has to appoint and co-ordinate with brokers to issue, principal brokers, bankers to issue, registrars to issue

- Marketing – Holding of road shows and issue of advertisement. In the issue of advertisement, prescribed SEBI guidelines are to be followed. Some of these guidelines are:

    i. All issue advertisements shall be truthful, fair and clear and shall not contain any statement, which is untrue or misleading.

    ii. As investors may not be well versed in legal or financial matters, care should be taken to ensure that the advertisement is set forth in a clear, concise and understandable language. Extensive use of technical, legal terminology or complex language and the inclusion of excessive details, which may detract the investor, should be avoided.

    iii. An issue advertisement shall not contain statements which promise or guarantee an appreciation of rapid profits

    iv. An issue advertisement shall not contain any information or language that is not contained in the offer document.

    v. All issue advertisement in newspapers, magazines, brochures, pamphlets containing highlights relating to any issue should also contain risk factors with the same print size. It should mention the names of lead managers, registrars to the issue.

vi. No corporate advertisement except product advertisement shall be issued between the date of opening and closing of subscript on of any public issue. Such product advertisement shall not make any
1724 reference directly or indirectly to the performance of the company during the said period.

vii. No advertisement shall be issued stating that the issue has been fully subscribed or oversubscribed during the period the issue is open for subscription, except to the effect that the issue is open or closed. No announcement regarding closure of the issue shall be made except on the last closing date. If the issue is fully subscribed before the last closing date as stated in the prospectus, the announcement should be made only after the issue is fully subscribed and such announcement is made on the date on which the issue is to be closed.

viii. No models, celebrities, fictional characters, landmarks or caricatures or the likes shall be displayed on or form part of the offer documents or issue advertisement

ix. No slogans, expletives or non-factual and unsubstantiated titles should appear in the issue advertisement or offer documents

x. If any advertisement carries any financial data it should also contain data for the past three years and shall include particulars relating to sales, gross profits, net profit, share capital, reserves, earnings per share, dividends and the books values.

xi. No incentives, apart from the permissible underwriting commission and brokerage, shall be offered through any advertisements to anyone associated with marketing the issue.

- Underwriting – The need for underwriting are to be properly evaluated after analysing the underlying underwriting risks and extant SEBI guidelines are to be respected. Merchant bankers will settle issues related to contingent

underwriting, underwriting commission rates, trends in underwriting, undersubscription and possibilities for devolvement.

- Pricing – Pricing of any issue is an important issue in pre-issue management. Pricing of rights and further public issues are basically decided by - free pricing of issues, book building, basis for issue price, premium fixation or pricing of shares, net asset value, PEC value, Market value and Fair value. Thus justifying the pricing, premium levels if any, would be decided by the merchant bankers in consultation with the company.

MANAGEMENT OF POST ISSUE ACTIVITIES

Post issue management consists of collection of application forms from bankers to the issue and the statement of amounts received, screening applications and deciding allotment procedure in consultation with stock exchanges. Post issue management concludes with the mailing of allotment letters / shares certificates and refunds orders. Listing requirements relating to allotment of stock exchanges also fall under post issue management.

Registrars to issue play a major role in the post issue management. They work in close collaboration with bankers to the issue. The task of getting applications together, sorting them and arranging them in an order is undertaken by the registrars to the issue. Merchant bankers assist the company by co-ordinating this activity till final allotment is made and allotment letters and refund orders are posted.

Registrars to the issue have to reconcile the total applications collected by the bankers to the issue on behalf of the company with the amount collected, cash/cheques/drafts/stock invests. They should verify the application received from the public and multiple applications and applications with technical defects or which do not conform to the conditions stipulated on the application form are removed and rejected. Registrars have to ensure that the applications are processed and allotment, share certificate / refund orders are sent within thirty days of the closure of issue.

The post issue activities in any public issue can be broadly classified as under:

- Allotment - Allotment is to be finalised within thirty days from the date of closure of subscription. In case of delay beyond this period interest at SEBI prescribed levels is payable on excess application money (not allotted) for the period of delay.
- Withdrawal of application – The advisory committee on primary market set up by SEBI suggested that there should be a time limit within which the investors can withdraw once the public issue is over instead of waiting till the date of finalisation of the basis of allotment which of course requires an amendment to the Companies Act.
- Listing requirement of stock exchanges and listing
- Mailing of share certificates – Must be done within thirty days of closure of subscription list.
- Refund – Must be done within thirty days of closure of subscription list

SERVICE ORIENTED ACTIVITIES

MERGERS AND AMALGAMATIONS:

MEANING

When two or more companies combine into one company, merger is said to occur. Indian laws use the term amalgamation for mergers. Section 2(1A) of the Income Tax Act 1961 defines amalgamation as the merger of one or more companies with another company or the merger of two or more companies to form a new company.

Mergers and amalgamations are generic terms referring to different types of business combinations wherein two or more firms combine to form one legal entity. Merger is a broader term and denotes the combination of two or more companies in such a manner only one survives while the other is dissolved. When two companies differ significantly in size they usually merge. Amalgamation is an arrangement whereby the assets of the two companies vested in one which has as its shareholders all or substantially all the shareholders of the two companies. Amalgamations are governed by Sections 390 to 394 and 396 of the Companies Act requiring consent of shareholders and creditors.

Mergers are normally congeneric where the business of the two firms are related. The congeneric mergers are further classified into horizontal and vertical mergers. In the case of horizontal mergers, the units are in the same business and the resulting increase in market share could lead to a monopoly situation - for example the merger of TOMCO with Hindustan Lever Ltd.

Vertical mergers are for upstream suppliers or for downstream distributors - for example the merger of Reliance Petrochemicals with Reliance Industry.

Therefore, a merger or amalgamation is treated as a purchase or pooling of interest. The pooling of interest method is used only in the case of amalgamation in the nature of a merger. In pooling, the balance sheets are combined. The total assets of the combined companies will not be enlarged. There is no good will and no future charge. Reported earnings will be higher.

As per accounting standard the following fi e conditions should be met if an amalgamation is to be treated as merger.

PURPOSE

The purpose of any merger or amalgamation is :

i. to limit competition

ii. to utilise under-utilised market power

iii to overcome the problem of slow growth and profitability in one's own industry

iv. to achieve diversification

v. to gain economies of scale and increase income with proportionately less investment

vi. to establish a transnational bridgehead without excessive start up costs to gain access to a foreign market

vii. to utilise under-utilised resources - human and physical and mangerial skills

viii. to displace existing management

ix to circumvent government regulations

x. to reap speculative gains attendant upon new security issue or change in P/E ratio

xi. to create an image of aggressiveness and strategic opportunism, empire building and to amass vast economic powers of the company

The advantages of mergers or amalgamations are:

i. maintaining or accelerating a company's growth, particularly when the internal growth is constrained due to paucity of resources

ii. enhancing profitability, through cost reduction resulting from economies of scale, operating efficiency and synergy

iii. diversifying the risk of the company, particularly when it acquires business whose income streams are not correlated

iv. reducing tax liability because of the provision of setting off accumulated losses and unabsorbed depreciation of one company against the profits of another

v. limiting the severity of competition by increasing the company's market power

TYPES OF MERGERS

There are two forms of Merger or amalgamation - merger through absorption or merger through consolidation

Absorption is a combination of two or more companies into an existing company. All companies except one lose their separate identities in a merger through absorption.

Consolidation is a combination of two or more companies into a new company. In this form of merger, all companies are legally dissolved and a new entity is created. In a consolidation, the acquired company transfers its assets, liabilities and shares to the acquiring company for cash or exchange of shares.

ROLE OF MERCHANT BANKERS IN MERGERS

Merchant bankers help in drawing amalgamation and merger schemes. They also assist in obtaining different permissions for this purpose.

PROCESS OF MERGERS / AMALGAMATIONS

A scheme of amalgamation or merger involving two or more companies requires the approval of the Court. Section 390 to 396 A of the Companies Act deal with provisions relating to merger / amalgamation. Normally, the process or amalgamation takes or covers the following steps:

i. formulation of the scheme
ii. articles of association - whether permits or needs amendments / alteration
iii. intimation to SEBI and Stock Exchange and notification
iv. Directors' approval of the proposed scheme
v. Shareholders' approval
vi. Application to the court
vii. Meeting ordered by the court of creditors and members of the company
viii. Petition for confirmation of amalgamation
ix. Order of the court

PORTFOLIO MANAGEMENT

MEANING AND OBJECTIVES

Portfolio management means managing the investment portfolio of a client. It involves investment of a client's funds in portfolio of stocks and securities and to buy and sell securities with professional acumen with an objective to achieve a higher return for the client.

MECHANICS OF OPERATIONS

Anybody who has sizeable amount (normally atleast Rs.1 lakh) for investment in securities (shares / debentures) can approach a merchant banker authorised by Securities Exchange Board of India to render portfolio management services.

The investor and the portfolio manager would then enter into a contract specifying the main objectives of the portfolio - like 1. High Risk - High Return 2. Low Risk - Moderate Return 3. Composition of securities, etc.

The contract would also specify about 1. Frequency of statement of account 2. Fees payable 3. Repayment time, etc.

After this, the portfolio manager makes investment as per the agreed terms.

SEBI GUIDELINES

The nature of service should be investment management or consultancy. It is to be rendered for an agreed fee. It should be entirely at customer's risk without any guarantee either directly or indirectly for any predetermined return.

Broad terms of the portfolio should be mentioned in a written contract.

No fund should be accepted for portfolio management for period less than one year.

The funds of clients should be kept in a separate account opened in a scheduled commercial bank. Account should be maintained clientwise.

Funds would be invested in capital market and / or money market instruments as per contract. Investment in bill discounting, badla financing, lending to corporate bodies and lending in call money market are prohibited.

SEBI has powers in respect of the following

i. to ask for returns / reports

ii. to inspect books of accounts

iii. to take necessary action including suspension / cancellation of authorisation of portfolio manager in case of violation of SEBI guidelines.

EXPLANATION TO RISK – CAPM – APPROACH TO MARKET OPERATIONS

Risk and return are most important concepts in finance. In fact, they form the foundation of the modern school of thought on investment. What is risk ? How it is measured ? What is return ? How it is measured ? Other related questions are: how are assets valued in capital markets ? How do investors make their investment decisions ?

We shall now attempt to answer these questions. Specifically, we shall discuss the concepts of risk and return, the logic of portfolio theory and the use of capital asset pricing model (CAPM) for valuing assets.

Risk means the uncertainty in the probability distribution of returns on shares and securities.

(Normally, the words risk and uncertainty are used interchangeably. Technically, their meanings are different. Risk suggests that a decision maker knows the possible consequences of a decision and their relative likelihood at the time he makes that decision. Uncertainty, on the other hand, involves a situation about which the likelihood of the possible outcomes is not known).

Risk in holding securities is generally associated with the possibility that realised returns will be less than the returns that were expected. Forces that contribute to variations in return – price or dividend (interest) – constitute elements of risk. Some influences are external to the company, cannot be controlled, and affect large number of securities. Other influences are internal to

the company and are controllable to a large degree. In investments, those forces that are uncontrollable, external, and broad in their effect are called sources of systematic risk. Conversely, controllable, internal factors somewhat peculiar to industries and / or companies are referred to as sources of unsystematic risk.

Systematic risk refers to that portion of total variability in return caused by factors affecting the prices of all securities. Economic, political and sociological changes are sources of systematic risk. Systematic risk covers the market risk, interest rate risk and purchasing power risk.

Unsystematic risk is the portion of total risk that is unique to a company or industry. Factors such as management capability, consumer preferences and labour strikes cause variability of returns in a company. Unsystematic factors are largely independent of factors affecting securities in general. Because these factors affect one company, they must be examined for each company. Unsystematic risk covers business risk and the financial risk. This can be managed through diversification.

Investors are interested primarily in eventually selling a security for more than they paid for it. Including the receipt of interest or dividends during the time the security is held, the investor hopes to achieve a higher reward than would have been possible by simply placing the same amount of money in bank. This reward, or return, can be measured and estimated for each security for decision making and the entire process is known as security analysis.

Return on a typical investment consists of two components. The basic component is the periodic cash receipts (or income) on the investment, either in the form of interest or dividends. The second component is the change in the price of the asset – commonly called the capital gain or loss. This element of return is the difference between the purchase price and the price at which the asset can be or is sold; therefore, it can be a gain or loss.

The income from an investment consists of one or more cash payments paid at specified intervals of time. Interest payments on most bonds / debentures are paid semiannually, whereas dividends on common stocks are usually paid

annually. The distinguishing feature of these payments is that they are paid in cash by the issuer to the holder of the asset.

Much time and effort has been expended on developing a measure of risk and a system for using this measure in assessing returns. Capital Asset Pricing Model is one such tool. This links risks to the level of required return.

As the name suggests, the CAPM approach to estimate risk adjusted discount rate is based on Capital Asset Pricing Model. The CAPM is a theory about how the prices of risky financial assets (securities) are determined in the capital market. In brief, the key insights of the CAPM are:

- Investors need be rewarded for systematic risk only because unsystematic risk can be reduced to zero through diversification of investment portfolio.
- Security systematic risk as measured by beta value
- The required rate of return on a security depends on riskless rate of interest, the market risk premium and the security's beta value.

The required rate of return on a security according to CAPM, depends on the riskless rate of return, the market risk premium and the beta value of the security. Computation of beta is perhaps the most critical step in the application of CAPM. Beta provides a market related measure of risk of a security and the CAPM provides a framework of estimating the required rate of return on a security. By substituting a capital investment project in place of security in CAPM, we can work out the required rate of return on an investment project or a similar investment project, which may then be as risk adjusted discount rate for project evaluation.

CAPM is based on a number of assumptions. The most important assumptions are:

- The capital markets are efficient. The capital market efficiency implies that share prices reflect all available information.

- Investors are risk averse They evaluate a security's return and risk in terms of the expected return and variance or standard deviation respectively. They prefer the highest expected returns for a given level of risk

- All investors have the same expectations about the expected return and risk of securities

- All investors' decisions are based on single time period

- All investors can lend or borrow at a risk-free rate of interest.

MISCELLANEOUS ACTIVITIES

VENTURE CAPITAL FUND:

NATURE OF VENTURE CAPITAL ASSISTANCE:

Venture capital as a source of long term financing for new industrial enterprises is essentially a concept of American origin where it has been a significant source of equity finance for a very long time. The concept of venture capital is gradually coming into vogue in developing countries but it is understood in somewhat different sense.

In one sense, venture capital refers to the risk capital supplied to growing private companies and it takes the form of share capital in the business firms. Money provided as start up capital and as development capital for small but growing firms is included in this definition. In developing countries venture capital concept has been understood in the above sense. In our country, venture capital comprises seed capital finance for high technology and funds to turn research and development into commercial production.

In another sense, venture capital refers to the commitment of capital for the formation and setting up of firms particularly those specialising in new ideas or new technologies. Thus it is not merely an injection of funds into a new firm but also a simultaneous input of skills needed to set up the firm design its marketing strategy, organise and manage it.

Proposals involving new, innovative or relatively untried technology being risky do not find favour with risk averse bankers or common investors. Venture capital funds are set up to provide funds for such enterprises. Thus a venture capital fund is one which provides finance for high risk and high technology ventures which are usually promoted by qualified entrepreneurs who lack business experience and funds to give shape to their ideas.

It can be by way of

i. participating in equity capital with or without buy back by the company

ii. normal long term loans

iii. conditional loans with option to convert a part / full loan to equity

Apart from financial assistance, venture capital fund also provides managerial / marketing assistance

Therefore the three important characteristics of venture capital are:

i. equity participation

ii. long term investment

iii. participation in management

In case of successful ventures after the venture reaches a certain stage of profitability, the venture capitalist sells his shares at a hefty margin in stock exchanges and realises the capital gain, which enjoys income tax concession.

Sometimes the venture capitalist contracts for certain percentage as royalty on sales made by the company. It can also arrange for profit sharing.

Term loans earn interest income.

ORIGIN

American Research and Development Corporation - ARDC established in Boston, USA, in the year 1946 by George Doriot was the first successful venture capital fund. The passing of Small Business Investment Company Act - SBIC Act in 1958 as a vehicle of small business financing gave real impetus to the development of venture capital industry in USA.

The most important feature of American venture capitalists is that they are totally involved with firms based on high technological innovation right from the

stage of conception of business ideas to the final stage of their establishment. They provide in addition to risk capital, managerial, commercial, technical, financial and entrepreneurial services so as to enable the firms to achieve optimum performance. They are almost a full fledged partner in the business along with the entrepreneur, sharing the risk and added value created in the process.

The British venture capital funds have certain special characteristics. They have come into existence to fill a gap in the market left unfilled by the banks and or various government schemes, that required close involvement in the management of the company being backed and in the planning and ownership of the company over a period of years. Some venture capitalists in UK provide funds right from the research stage.

Venture capital as a source of launch capital either of American type or the slight variant British type is, by and large, absent in India. There are of course some institutional venture capital funds / schemes in operation in India.

Popular Indian venture capital companies are:

TECHNOLOGY DEVELOPMENT AND INFORMATION COMPANY OF INDIA LTD - TDICI

Formed by ICICI and UTI

Provides equity / conditional / normal loan to high tech - high risk and high rewarding new projects promoted by first generation professional entrepreneurs

Quantum of finance depends on the need of the project

RISK CAPITAL AND TECHNOLOGY FINANCE CORPORATION LIMITED - RCTFC

Formed by IFCI - Head Office at New Delhi

Provides assistance between Rs.15 lakhs to Rs.40 lakhs to first generation entrepreneurs as equity or conditional loan

INDUSTRIAL DEVELOPMENT BANK OF INDIA'S VENTURE CAPITAL FUND

IDBI operates a venture capital scheme - assistance is provided only by way of unsecured loan

CREDIT CAPITAL LIMITED

First venture capital company in private sector in India.

Also the first finance company in India in which Asian Development Bank, Common Wealth Development Corporation and International Finance Corporation have equity stake

ADMINISTRATION

Steps in venture financing

1.Initial financing

- seed capital for supporting an idea or concept
- research and development support for product development
- start up capital for initial production and marketing
- first stage financing for full scale production and marketing

2.Expansion financing

- working capital and initial expansion
- facilitating public issue and development financing
- bridge financing for facilitating public issue

3.Acquisition / buyout financing

- acquisition financing for further growth
- management buyout financing for enabling operating group to acquire firm
- turnaround financing

Method of venture financing

1725 1. Equity

2. Conditional loan - repayable in the form of royalty after the venture is able to generate sales

3. Income Note - hybrid security - a combination of conventional and conditional loan to pay both interest and royalty on sales at substantially low rates

VENTURE CAPITAL ASSISTANCE PARAMETERS IN INDIA

Assistance to a unit should fulfill the following parameters

i. size - total assistance per unit should not exceed Rs.10 crores

ii. technology - unit should adopt new / relatively untried / very closely held / taken from pilot to commercial stage

iii. entrepreneur - should be relatively new, professionally or technically qualified, with inadequate resources or lacking to finance the project

IMPLICATIONS FOR DECISION MAKERS

i. The business plan - key document associated with venture capital financing. The potential investor may get some idea of the new product or service, the scale of the opportunity, the size of the task involved, the progress to date, the risks, the funding requirements and above all the track record of the promoters.

ii. The investors - The entrepreneur frequently puts himself in a position of seeking backing from investors, whereas a more positive approach is that of offering an opportunity for shared gain. Good entrepreneurs are often sought out by venture capital investors, and headhunters to establish potential new ventures are

not unknown. The entrepreneur should choose his prospective venture capital investor on the basis of track record, experience and industry knowledge as well as on the financial aspects of the deal offered.

iii. The entrepreneur - is the key participant.

iv. The business idea - major determinant of success

v. The public offering

Venture capital has come to play a significant role in corporate development in different parts of the world. Venture capitalists supply risk capital and skills to firms specialising in new ideas or technologies. They are associated with successive stages of the firm's development and render multiplicity of services to firms at every stage.

Venture capitalists have a different mindset and look for entirely different qualities in an entrepreneur unlike conventional lenders who are generally cautious in approach and tend to lend against collateral. The venture capitalist on the other hand lends against innovative, untested ideas and the test of a venture capitalist lies in the success stories. When a venture capitalist lends, his focus is on the entrepreneur, his ideas, his future market perceptions, and his dreams. Venture capitalists cannot bank on conventional lending wisdom because their borrowers have nothing more to offer except ideas. Therefore, the due diligence exhibited by venture capitalist is intense.

MUTUAL FUNDS

A mutual fund is one, which pools resources from several investors and manages the same with an objective to maximise returns for these investor members.

A mutual fund is an intermediary institution, which pools the resources collected from the public, and invests them in profitable avenues. The fund uses these savings for investment in debentures and equity shares of various

companies, bonds, government securities, etc. The resulting earnings are distributed among the investors.

ORIGIN

The concept of mutual is not new to the world, though in India it is some what of a recent origin. The Societe Generale de Belgique, which was formed in 1822, embodied the concept of risk sharing. The Foreign and Colonial Government Trust of London was the real pioneer in the field of mutual fund. By the 1930's a large number of close ended mutual funds had been formed in the United States of America. Subsequently hundreds of mutual funds both open and close ended have been developed and expanded in many countries in Europe, the Far East and Latin America. All over the world, there has been a sharp increase in investor preference for mutual funds and India has proved to be no exception.

Unit Trust of India started the first mutual fund scheme in India. From 1987 commercial banks / financial institutions are permitted to float mutual funds through their subsidiaries. In 1991, following the recommendations of Dave Committee, the Government of India permitted private sector to float mutual fund. In 1992, as per recommendations of Dipankar Basu committee, banks and financial institutions are permitted to money market mutual funds.

ADVANTAGES

A mutual fund would give a nominal return of about 12 to 13.5% depending on the general economic scene. This is higher than 10% return on a fixed deposit from any commercial bank.

A fixed deposit does not carry any tax benefits for the principal saved. The interest earned is only one category of income, which can be claimed along with other categories for tax deductions under Section 80 L of the Income Tax Act. A mutual fund does carry tax benefits, which vary depending on the scheme launched by banks.

The investor gets protection against inflation because the mutual fund's return would also be automatically indexed against inflation since a higher

inflation rate would normally be associated with a higher dividend rate too as companies would be having nominal sales and profits.

While fixed deposits are risk free, there is no scope for appreciation of the investment made other than getting a return by way of interest. A mutual fund offers scope for capital appreciation in terms of the value of the units. This would be in tune with the profits earned by the fund along with the general performance of the economy.

Mutual funds provide safety, liquidity and growth to investors. The funds provide stability to share prices, safety to investors and resources to promoters and entrepreneurs.

Small investors with a few thousand rupees to spare do not have knowledge of stock market operations. There is also lack of reliable advice - there is absence of trust between the small investors and brokers and the brokers are indifferent to small investors because of poor pickings. But, mutual funds have changed the scenario. There is specialisation in the reduction of risk and economies of scale.

CLASSIFICATION OF MUTUAL FUNDS

In the funds market, many types of funds are offered to the investors. His choice of a fund will depend on what he wants his money to earn for him and how much risk he is willing to assume. Most of the funds will fall in one of the following categories.

i. open and close ended funds - if the period and / or target amount of the fund is definite, the fund is called close ended. If indefinite, it is called open ended.

ii. Income and growth oriented - the income oriented fund aims at distribution of income periodically amongst investors. On the other hand, the growth oriented fund meets the investors, need for appreciation, high risk bearing capacity and ability to defer liquidity.

iii. Taxation fund - some funds are designed to avail certain tax exemptions, whether in the domestic or foreign capital markets.

iv. Money market mutual funds - invested in short term money or short term financial assets, which are close substitute for money. The term short term in Indian context means a period not exceed one year.

v. Area, industry, customer, group funds - the funds may have investment in securities of a specified areas.

FORMATION OF MUTUAL FUNDS

Mutual funds are to be established in the form of trust under Indian Trust Act and are to be managed by separate Asset Management Companies - AMCs

AMCs will be authorised by SEBI.

They shall have minimum net worth of Rs.five crores.

An AMC or its affiliate cannot act as manager of any other fund.

The sponsor must contribute minimum 40% of the paid up capital of the AMC.

As per SEBI directives, the Board of Directors of an AMC should have minimum 50% of its directors from outside not connected to sponsoring organisation.

AMCs and Trustees of Mutual Funds are to be two separate legal entities. As per SEBI guidelines the Board of Trustee should have minimum four members and atleast 50% of them should be outsiders. The chairman of the sponsoring bank cannot be made chairman of the Board of Trustee, though he is permitted to be a member.

Mutual funds dealing primarily in capital market and also partly in money market instruments are to be regulated by SEBI. They must get authorisation from SEBI to start business.

Mutual funds dealing exclusively in money market instruments are to be regulated by RBI.

All schemes floated by mutual funds are to be registered with SEBI.

Each close end scheme must have a minimum corpus of Rs.20 crores while each open ended scheme should have minimum corpus of Rs.50 crores.

Where subscription under a scheme is less than 60% of the target amount or the required minimum of Rs.50 crores in the case of open end fund and Rs.20 crores in the case of close end fund the ~~entire~~ subscription has to be refunded to the investors.

No mutual fund under all its schemes put together should own more than 5% of any company's paid up capital carrying voting rights.

No mutual fund under all its schemes put together can invest more than 10% of its funds in shares / debentures or other instruments of any single company.

No mutual fund, under all its schemes put together, can invest more than 15% of its funds in shares and debentures of any specific industry except when the schemes which are specifically floated for investment in one or more specified industries and in respect of which a declaration has been made in the offer letter.

No individual scheme of mutual funds can invest more than 5% of its corpus in the shares of a particular company.

Mutual funds can invest only in transferable securities either in the money or capital market. Investment in privately placed debentures, securitised debts and

other unquoted debt instruments cannot exceed 10% in case of growth funds and 40% in case of income funds.

A mutual fund cannot invest in immovable properties, cannot give loans either directly or indirectly, cannot underwrite shares, cannot discount bills and cannot keep deposits with companies and other body corporates.

Mutual funds are required to distribute atleast 90% of their profit annually in any given year.

Companies tapping the primary capital markets are permitted to reserve 10% of the proposed issue for subscription by Indian Mutual Funds.

WHY GUIDELINES ARE CONSIDERED NECESSARY?

The guidelines have become necessary for the following reasons

- to protect the interests of small investors and ensure that the practices and operations of mutual funds contribute to a healthy and orderly growth of capital market
- to ensure that public confidence in the system is not eroded due to inefficient management of mutual funds
- in the interest of investors and mutual fund themselves that certain standard prudent accounting practices are followed by all the mutual funds uniformly so that it would be easier for the investors to judge the efficiency of different mutual funds sponsored by different institutions.

FUTURE OF MUTUAL FUNDS IN INDIA

The future of mutual funds in India is inextricably linked to the growth of Indian economy domestic savings, investment patterns, government policy towards private sector and the development of capital market. The government has provided the required impetus for launching of the funds by providing tax concessions and tax exemptions.

FACTORING - MECHANISM AND TYPES OF FACTORING

Factoring is an arrangement under which a factor purchases and / or administers the receivables of a concern. The dictionary says that is "the work of a factor" i.e. the business of buying up trade debts or lending money on such security.

To put it in simple terms, it is nothing but selling the debts customers owe to a business entity to another party, a factor, through an arrangement entered into with the factor and the client, the former undertakes the responsibility of handling all the client's receivables.

The parties to any factoring arrangement are the factor, the client and the creditor or customer. The factor is the party who buys the third party debts, the client is the party who sells his / her debts to a third party and the creditor or customer is the party who owes the debt.

The services offered by a factor can be some or all of the following - administration of sales ledger of the client, service to follow up and collect the receivables, purchasing receivable with recourse and purchasing receivables without recourse.

DIFFERENT TYPES OF FACTORING SERVICES:

Full factoring (purchase without recourse), recourse factoring (where the credit risk continues to be with the client) and invoice factoring (same as bill discounting)

A factoring can also be a notified factoring in which the customer is intimated about the assessment of debt to a factor and also directed to make payments to the factor instead of to the firm. This is invariably done by a legend on the invoice, which states that, the receivables arising out from the invoice has been assigned to or sold to the factor.

Non notified or confidential factoring is one in which the client / factor arrangement is not declared to the customer unless or until there is a breach of the

agreement on the part of the client or exceptionally, where the factor considers himself to be at risk.

MECHANICS OF FACTORING:

Stage 1: The client sells the goods to the buyer and prepares an invoice with a notation that debts due on account of this invoice is assigned to and must be paid to the factor

Stage 2: Then he submits the invoice copy alongwith delivery challan (showing receipt of goods by buyer) to the factor.

Stage 3: The factor, after scrutiny of these papers allows payment upto pre-agreed percentage of the invoice value. The drawing limit is adjusted on a continuous basis after taking into account collection of factored debts.

Stage 4: Once the invoice is honoured by the buyer on the due date, the retention money is released or credited to the client's account

Stage 5: Till the payment of the bill, the factor follows up the payment and sends regular statements to the client.

Charges: Factors charge a discount on the advance amount drawn by the client, a rate which is comparable to bank lending rates, in addition to a service charge (usually between one to three percent)

Broadly, there are two main types of charges - initial payment charge (IPC) and factoring charge (FC). IPC is the cost payable to the factor for the cash advances made. This is equivalent to the interest charges. FC referred to also as service charge or factoring commission, is the cost incurred by the factor for rendering, either of the whole or part, of administrative services relating to sales ledger administration, collection of debts and underwriting the credit risks involved.

FACTORS IN FACTORING:

Profile of a good factoring candidate -

Rapid growth in its present start up phase, with a good sales niche, satisfied customers;

Product permits markups to cover factoring costs and does not require substantial after sales service or involve long term payment;

Inventory (such as imports) must be purchased well before sales;

Accounts receivables are reliable and unencumbered;

The company may also be one that is in its mature stage in the business cycle, using factoring to supplement other forms of long term financing.

ADVANTAGES OF FACTORING:

Management adds cash to the bottom line and improves the debt to equity ratio. No long term negative implications to the balance sheet.

Advance inventories can be purchased despite cash flow shortages. Temporary reversals need not have a negative effect.

Slow paying customers can be carried at little or no charge.

High-growth start up can finance growth on a current basis.

A seed company, can, in effect, borrows money with no credit rating.

The cost of money is low or non-existent if the unit sales price of products can be marked up.

Many factor companies require no minimum volume of amount. Factoring can be a one time only strategy although frequent factoring results in higher rates and or deeper discounts on the asset.

DISADVANTAGES OF FACTORING:

Unless the company can mark up the sales price of its products, the cost of short term money can be high.

Relationship with customers might be jeopardised by the loss of personal contact - especially so if the factor company is not tactful in collecting the amounts owing.

A bad credit rating can result in additional factor fees and less favourable contract terms.

Factoring can reduce revenue, earnings or accounts receivables unless there is a matching increase in cash.

DIFFERENCE BETWEEN FACTORING AND BANK FINANCE AGAINST RECEIVABLES:

A factor can purchase receivables without recourse, which a bank does not do. Actual purchase of debt is unique feature of factoring. A factor offers a package of services for administering receivables, which the bank does not provide.

DEVELOPMENTS OF FACTORING IN INDIA:

Kalyanasundaram Committee (appointed by RBI in 1988) recommended for introduction of factoring services in India. Commercial banks can start factoring activities through their subsidiaries (Banking Regulation Act was amended in July 1990 to provide for the same)

RBI has permitted State Bank of India, Punjab National Bank, Allahabad Bank and Canara Bank to form factoring subsidiaries to cater to the needs of western, northern, eastern and southern parts of the country respectively. Accordingly State Bank of India has formed SBI Factoring and Financial Services Ltd (in April 1991 with a paid up capital of Rs.25 Crores) and Canara Bank has formed Can Bank Factors Ltd (in August 1991 with a paid up capital of Rs.10 Crores)

MARKETING OF MERCHANT BANKING SERVICES

Like in any other product, in merchant banking also the focus would be on the customer and his requirements. Accordingly, the merchant banker would design his products and services to suit the requirements of his customer.

Normally, the customer may not be new as such to the merchant banker. He might have enjoyed his services at some time or other or might be enjoying some facilities now. A pro-active merchant banker would experiment "cross selling concept" to offer some more of his services.

Most of the merchant bankers being commercial banks in the market place, the merchant banker is in possession of the various activities undertaken by their customers and their proposed activities like expansion, diversification, integration, etc. The merchant banker would seize the opportunity and offer his customer with his services. May be, he may also undertake loan syndication requirements of his customer, in case, as a commercial banker to the customer, he is not in a position to meet his entire credit needs.

The merchant banker would also source the market for news and collect market intelligence report on the credit requirements and other funds raising activities of a prospective customer. In this direction, the merchant banker would look in closely for press reports issued by companies in the market place. He would also process the financial results and annual reports of the companies.

He would also utilise actively the broker network in the market place. He would also maintain excellent rapport with the state financial corporations and industrial development corporations. At the national level, he would maintain cordial relations with developmental financial institutions. All these with a view to collect information about the prospective customers.

There is also a monthly magazine by name "Prime Directory" which furnishes the details of new companies and project details of proposed expansion plans of existing companies. This is a very good source for getting information in the market place.

Public relations with others connected in merchant banking activities like registrars, advertisers, brokers, etc also will help the merchant banker to get uptodate information on merchant banking requirements of prospective customers in the market.

More than sourcing information about the prospective customers, it is equally important for a merchant banker to continuously innovate new product and services to suit the changing requirements of customers. Instead of the customer asking for a particular service or product, the merchant banker after ascertaining his needs, should design suitable product / services. He should ensure proper briefing and continuous education of his customer to retain him in his fold. This can be appreciated from the fact that the percentage of securing fresh business from an existing customer is more than the chance of securing fresh customer. Customer retention is therefore very important in merchant banking activities.

Some of the unique selling propositions (USPs) in merchant banking activities are:

- speedy decision making
- ability to innovate new product / services
- past track record and image in the market place
- regional considerations or locational advantages
- product / service pricing
- proficiency in preparation of documents
- investment capabilities
- placement power.

MODEL QUESTION PAPER – I

MERCHANT BANKING

Time: 3 Hours | Maximum: 100 Marks

Part A (5x8=40)

Answer any ten questions

Each answer need not exceed one page

1. What do you mean by merchant banking ?
2. What is portfolio management ?
3. What is mutual fund ? State any two advantages of investing in a mutual fund
4. Emphasise the importance of credit rating
5. What are the functions of depositories ?
6. List down the steps in syndication
7. What are the benefits offered by a factor to his clients ?
8. What do you mean by (a) non voting shares and (b) zero coupon convertible bonds ?

Part B (4 x 15 = 60)

Answer any three questions

Each answer need not exceed five pages

9. Explain the various services offered by a merchant banker.
10. Explain the problem areas of an enterprise
11. In a depressed capital market, the merchant banker has little / no role to play – Do you agree ? Elaborate.
12. Discuss the role of the SEBI in regulating the merchant banking industry
13. As a portfolio manager, suggest tips for better investment decisions in the present day context.
14. What do you understand by mergers? What are the main purposes behind mergers? What are different types of mergers? Do you agree, in the present day Indian setup, companies to merger to face on slaught of competition? Why?
15. What are the different stages of venture capital finances? Briefly explain.

MODEL QUESTION PAPER - II

Merchant Banking

Time: 3 Hours | Maximum: 100 Marks

Part A (5 x 8 = 40)

Answer any ten questions

Each answer need not exceed one page

1. Who is a merchant banker ?
2. Explain the term underwriting
3. What are the different roles played by a merchant banker in the management of capital issues ?
4. What is a money market mutual fund ?
5. What is bridge finance or bridge loan ?
6. What do you mean by promoter's quota ?
7. What are the SEBI guidelines on portfolio management ?
8. What do you understand by the term 'loan syndication' ?

Part B (4 x 15 = 60)

Answer any three questions

Each answer not to exceed five pages

9. Briefly explain the range of merchant banking services offered by any banker.
10. What are the important activities in issue management ?
11. What is a mutual fund ? Trace the development of mutual fund in India ? Mutual funds are safe bet for small investors. Do you agree ? Why ?
12. Explain briefly the different form of securities offered in the capital market
13. You are selected by a merchant banking company responsible for marketing of its products and services. Explain how you would go about in your job ?
14. What are the different types of factoring services? Briefly explain. Also bring out the mechanics of factoring arrangement. What are the advantages of factoring.
15. What are the project related activities and corporate counselling undertaken by a merchant banker?

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